91-552

Supreme Court, U.S.
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No. _____

IN THE

SUPREME COURT OF THE UNITED STATES

October Term 1991

RONALD COLEMAN, NANCY COLEMAN, HARVEY COLEMAN, CAROL COLEMAN, WILLIAM COLEMAN AND ARLETTE COLEMAN,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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QUESTIONS PRESENTED

1. Whether the Commissioner of Internal Revenue ("Commissioner") has an option to require that a taxpayer pay tax based on the form of a transaction rather than the economic substance.

2. Whether a transfer of title to a lender which creates a security interest under United States law may, at the Commissioner's option, be treated as a transfer of ownership if the property is located in a country which treats the titleholder as the owner.

3. Whether the Commissioner, after increasing tax by preventing a taxpayer from showing that the economic substance of a transaction differs from its form, may impose a penalty for underpayment of tax under IRC §6661.

4. Whether the Commissioner may impose penalties for underpayment when additional tax is imposed on the basis of a controversial point of law on which other circuit courts of appeal would have reached an opposite result.

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OPINION BELOW

The Court of Appeals issued no opinion. The opinion of the United States Tax Court is reported at 58 T.C.M. 125 (1990) and is reproduced in the Appendix.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on May 22, 1991 and this petition was filed within 90 days of that date. This Court has jurisdiction under 28 U.S.C. §1254(1). The Court of Appeals for the Third Circuit had jurisdiction and venue of the appeal from the Tax Court under 26 U.S.C. §7482 (b)(1)(A) because the petitioners are residents of New Jersey.

STATUTORY PROVISIONS INVOLVED

Internal Revenue Code §6661, 26 U.S.C. §6661, is reproduced in the appendix of this petition.

STATEMENT OF THE CASE

The petitioners are three brothers and their wives. The brothers are equal general partners in a partnership ("Majestic"), which purchased computers and peripheral equipment located in England.

The purchases were financed by loans from English lenders, who took title and were named as lessors in

leases to six English users. Under United Kingdom tax law the lenders, as title holders, received tax write offs and for this reason charged less interest than they would have if title had not been transferred to them. The lessees paid rentals directly to the lenders, who applied them to the payment of the purchase money indebtedness. Majestic received options from the lenders to acquire title for nominal consideration when the respective loans were fully paid.

In a prior case, involving the petitioners' tax years 1979 and 1980, the Tax Court held that the petitioners were not entitled to take depreciation deductions with respect to the equipment. The Tax Court issued two different opinions in that case. It withdrew the first (reported at 85 T.C. 622) when petitioners pointed out a number of legal and factual errors in the opinion. In its second opinion (reported at 87 T.C. 178) the Tax Court did not repeat the errors, but it again ruled against the petitioners, though on an entirely new theory, which the Tax Court advanced *sua sponte*.

The Tax Court stated that the petitioners were seeking to look through the form of the transactions with the English lenders to the substance, a privilege, which

the Tax Court held, is accorded only to the Commissioner (with very limited exceptions). The Tax Court added at 87 T.C. 202:

> Furthermore, the ability of a taxpayer to avoid the consequences of the form of a transaction is even more restricted in the Third Circuit Court of Appeals, to which an appeal in this case would lie.[1]

The Tax Court declared that the English lenders' titles were prima facie evidence of ownership, which the petitioners had failed to rebut by "strong proof." (The Tax Court apparently did not regard Majestic's options to acquire title for nominal consideration after the loans were paid to be "strong proof.")

Because the Commissioner had raised no objection based on the form of the transaction and the Tax Court reached its second decision in the 1979-80 case *sua sponte* without requesting briefs from the parties, petitioners were unable to point out that there actually was no difference between form and substance under

[1]The Tax Court cited *Commissioner of Internal Revenue v. Danielson*, 378 F.2d 771 (3d Cir. 1967) cert. denied, 389 U.S. 858, 88 S.Ct. 94, 19 L.Ed.2d 550 (1967) and *Sullivan v. United States*, 618 F.2d 1001 (3d Cir. 1980) discussed below at pages 9 and 10.

United States law. Majestic's options to acquire title for nominal consideration made Majestic the owner under the Uniform Commercial Code §1-201(37)(d) which would treat the English lenders as holders of a security interest.[2] Petitioners also were unable to show the Tax Court that under common law as well Majestic was entitled to prove that conveyances absolute on their face were only security for loans.[3]

Although petitioners made these points on the appeal to the Third Circuit Court of Appeals, that Court

[2]U.C.C. §1-201(37)(d) provides: [A] transaction creates a security interest if the consideration the lessee is to pay the lessor for the right to possession and use of the goods is an obligation for the term of the lease not subject to termination by the lessee, and;***

> (d) The lessee has an option to become the owner of the goods for no additional consideration or nominal additional consideration upon compliance with the lease agreement.

The IRS reached a similar conclusion for tax purposes in Revenue Ruling 55-540, 1965-2 C.B. 39 and Revenue Ruling 68-590, 1968-2 C.B. 66.

[3]The principle is well established at common law, that a conveyance which is in form absolute may be shown to have been intended only as a mortgage ("a mortgage is always a mortgage"). 55 Am. Jur.2d 224 (real property), 68 Am. Jur.2d 922 (personal property). There is uncontradicted evidence in the record that the lender-lessors intended a security arrangement.

affirmed in a one sentence opinion "substantially on the opinion of the Tax Court." Accordingly it appears that the Third Circuit concluded that the petitioners could not look through the form of the transaction for tax purposes even to the extent of showing that there was no difference between the form and the substance because the form would be disregarded for purposes of commercial law.[4]

The present case involves five subsequent tax years, as to which there was an important change of circumstances. All the user leases expired, and Majestic's options to acquire title from the English lenders for nominal consideration became immediately exercisable. After the Third Circuit decision in the 1979-80 case, the petitioners filed amended tax returns in which they claimed depreciation deductions only from the dates the options became exercisable rather than from the earlier date of Majestic's purchase of the equipment (as they had done on their original returns). Petitioners' position

[4]Although the Third Circuit affirmed without any opinion at all, petitioners believe that this is what the Third Circuit intended, because petitioners, as they had in the first case, pointed out the absence of any difference between form and substance.

is that once the options became exercisable, the Commisioner could not reasonably argue that Majestic had merely a future (and, therefore, non-depreciable) interest.

Under a stipulation between the petitioners and the Commissioner, the present case was submitted to the Tax Court on the record in the 1979-80 case plus the amended tax returns and the Commissioner's proposed assessments for the years 1981 through 1985.

The Tax Court ruled against the petitioners, this time for a different reason. Because in 1979 and 1980 none of the options were exercisable, there was no direct evidence in the record of the 1979-80 case that they had been exercised. The Tax Court rejected undisputed circumstantial evidence in the 1979-80 record, such as a contractual obligation to exercise the options and the substantial economic advantages that would ensue from exercising the options. There was *no* evidence that the options had *not* been exercised. The Tax Court ruled, however, that in the absence of *direct* evidence of exercise of the options, the tax situation of petitioners in the five years covered by this case is indistinguishable from that in 1979 and 1980. It also sustained the

Commissioner's imposition of penalties for the later years although there had been no penalties imposed for 1979 and 1980. The Third Circuit Court of Appeals affirmed without opinion.

REASONS FOR GRANTING THE WRIT

The Tax Court, in disallowing the deductions claimed by petitioners, based its opinion in the 1979-80 case largely on the circumstance that an appeal would be to the Third Circuit Court of Appeals. In the Third Circuit the ability of a taxpayer to look behind the form of a transaction to the economic substance is more narrowly circumscribed than in other circuits. Indeed, in *Schmitz v. Commissioner*, 51 T.C. 306, 316 (1968), the Tax Court declared that it would not apply the Third Circuit's restriction in cases appealable to other circuits. That is, of course, intolerable. The amount of federal income tax one owes should not depend on the judicial circuit in which one resides.

The question of a taxpayer's ability to rely on the substance of a transaction rather than form has significant ramifications in many branches of tax law.

The present case happens to involve transactions called leases but that are really financings. However, there are many other instances in which business considerations dictate the use of a particular form that, taken literally, does not reflect the economic substance. Accordingly, the question of whether a taxpayer is bound by form or may look to substance is one of frequent occurrence and wide ranging application in the administration of the Internal Revenue Code.

For example, what amounts to a sale of assets may be effected through a statutory merger when particular assets can not readily be transferred, e.g., franchises or certificates of necessity and convenience. A document called a purchase agreement in reality may be only an option. Property may be held in the name of a nominee for non-tax reasons. A guarantee of a corporate loan may actually be a loan to the guarantor and a further loan to the corporation. What is in form a note really may be equity. An instrument called stock may in fact represent a debt. A deed absolute on its face may be a mortgage. An insolvent corporation may be "reorganized" by a sale to a creditor's committee followed by a transfer to a new corporation. These are examples of recurrent

situations whose tax status is uncertain under the Third Circuit rule.

This case raises three issues whose resolution is important in the administration of the Internal Revenue Code. First is under what circumstances may the Commissioner compel a taxpayer to pay tax based on the form of a transaction rather than the economic substance?[5] The Third Circuit and other circuits have reached conflicting conclusions on this question.

Second, if the Commissioner elects to increase tax liability on the basis of the form, ignoring substance, may he in addition impose penalties for underpayment of tax?

Third, may penalties for underpayment of tax be imposed by the Commissioner when a taxpayer is held subject to tax on the basis of a controversial point of law on which other circuit courts of appeal would have reached an opposite result?

[5]In this case the Commissioner did not initiate the compulsion. In effect he ratified the compulsion on his behalf by the Tax Court *sua sponte*.

POINT I

THE "DANIELSON RULE" OF THE THIRD CIRCUIT IS IN CONFLICT WITH DECISIONS OF THIS COURT AND OF OTHER CIRCUITS AS TO WHEN A TAXPAYER MAY RELY ON ECONOMIC SUBSTANCE NOTWITHSTANDING THE FORM OF A TRANSACTION.

The highly restrictive Third Circuit rule was enunciated in *Commissioner of Internal Revenue v. Danielson*, 378 F.2d 771 (3d Cir. 1967), cert. denied, 389 U.S. 858, 88 S.Ct. 94, 19 L.Ed.2d 123 (1967), an *en banc* decision by a majority of four judges with three judges vigorously dissenting. In that case sellers of corporate shares claimed that amounts they received for covenants not to compete actually were payments for the shares and should be taxed as capital gains rather than ordinary income. The sellers and purchasers had agreed on the allocation of the consideration between shares and the covenant, and the sellers had received a premium price for accepting a larger allocation to the covenant. There existed potential conflicting tax claims, because the purchaser could deduct payments made for the covenant not to compete but not payments for the shares.

The Third Circuit held that a taxpayer must "be held to his agreement absent proof of the type which would negate it in an action between the parties to the agreement." 378 F.2d at 777. The Court cited as examples "fraud, undue influence and the like on the part of the other party* * * by a party claiming that because of fraud, etc., it is not his conscious agreement." The test adopted by the Third Circuit in *Danielson* was novel and of very dubious validity, as the three dissenting judges argued.

Nevertheless, in *Sullivan v. United States,* 618 F.2d 1001 (3d Cir. 1980), the Third Circuit extended its *Danielson* rule even to cases in which tax considerations did not enter into selecting the form of transaction. The Court said at 618 F.2d 1007:

> Even if we assume, arguendo, that tax considerations could not have played any role in the formation of the parties' agreement here, however, that fact alone would not appear to justify excluding this case from the scope of *Danielson.* On the contrary, the *Danielson* rule appears on its face to apply generally and without limitation to cases in which a party attempts to challenge the tax consequences of his own agreement.

In the present case the Third Circuit appears to have further extended its *Danielson* rule to a situation in which there is no substantive difference between form and substance, because the form would not be given effect under commercial law.

Here, furthermore, there was no potentiality that the Commissioner would be confronted with conflicting claims by two different taxpayers. The English lenders are not subject to United States income tax. If petitioners are allowed the deductions for depreciation they claimed, there is no danger that the English lenders, as holders of legal title, will claim the same deductions a second time.[6] As is shown below, since there is no possibility of a conflicting claim, if the taxpayers had resided in Texas or Illinois rather than in New Jersey, the deductions would have been allowed.

The Fifth Circuit, in *Weinert's Estate v. Commissioner of Internal Revenue,* 294 F.2d 750 (5th Cir. 1961), applied

[6]Even if the lenders were subject to United States income tax, the tax consequences of their retention of title would be determined by American tax law principles not those of the United Kingdom. *Biddle v. Commissioner,* 302 U.S. 573, 58 S.Ct. 379, 82 L.Ed. 431 (1938), *United States v. Goodyear Tire and Rubber Company,* 493 U.S. ____, 110 S.Ct. 462, 107 L.Ed.2d 449 (1989).

a very different criterion from the *Danielson* rule in permitting a taxpayer to show that a transaction, which in form was a loan secured by a lien on an oil and gas lease, was in economic substance a "carried" interest or a "carved out" production payment. The Court said at 294 F.2d 755:

> Resort to substance is not a right reserved for the Commissioner's exclusive benefit, to use or not to use -- depending on the amount of the tax to be realized. The taxpayer too has a right to assert the priority of substance --at least in a case where his tax reporting and actions show an honest and consistent respect for the substance of a transaction.

In *Weinert's Estate* there was no likelihood of conflicting tax claims, because treating the transaction as a carried interest or production payment instead of a loan was favorable for both parties. The carrying party (the nominal lender) was entitled to intangible drilling deductions and would be entitled to depletion on income from the carried interest or production payment, benefits which would be unavailable to the carrying party if the transaction were a loan to the carried party.

Other circuits have expressed similar opinions. *Comdisco Inc. v. United States,* 756 F.2d 569, 578 (7th Cir. 1985) (when "the Government will never be faced with conflicting claims. . . . we abandon the approach that binds a taxpayer to the labels given to the transaction in favor of an analysis that looks at the economic substance of the transaction. . . . A taxpayer whose transactions meet in substance a clear expression of Congressional intent, as it does here, for inclusion in a tax benefit should not invariably be at the mercy of governmental whim to decide which route to take, dependent, often it seems, on which way revenue will be produced."); *Selfe v. United States,* 778 F.2d 769 (11th Cir. 1985) (reversing a summary judgment in favor of the Commissioner, who had argued that the taxpayers are "bound by the 'form' of the transaction and may not argue that the 'substance' of their transaction triggers different tax consequences;" case remanded for a determination of whether or not bank primarily looked

to the taxpayer for repayment of corporate loans).[7]

Prior to *Danielson* other circuits had permitted taxpayers to look to substance rather than form. *J.M. Turner and Company v. Commissioner of Internal Revenue,* 247 F.2d 370 (4th Cir. 1957) (corporation could treat a subscription to its shares followed by the purchase of assets from the subscriber as in substance a direct transfer of the assets from the subscriber to the corporation. "It is the substance, not the form, of the transaction, which must control our conclusion, and a transaction accomplished in two mutually dependent steps should be viewed as a whole."); *United States v. Title Guarantee and Trust Company,* 133 F.2d 990 (6th Cir. 1943) (taxpayer permitted to show that certificates for preferred stock were really debt instruments and to deduct the "dividends" as interest. "[T]he cases agree that the decisive factor is not what the payments are called, but what in fact they are.").

[7]In an earlier case, however, the Eleventh Circuit considering itself bound by the Fifth Circuit ruling in the *Specter* case discussed below at page 17, followed the *Danielson* rule in a case in which there *were* potential conflicting tax claims. *Bradley v. United States,* 730 F.2d 718 (11th Cir. 1984).

See also *Frelbro Corporation v. Commissioner of Internal Revenue,* 315 F.2d 784 (2d Cir. 1963) (taxpayer permitted to show that a payment in form a dividend of $61,589.56 was actually only a dividend of $9,384.65 and that $52,213.91 was merely an exchange of checks; "We do not believe that we are obliged, as the government urges upon us, to regard only the form of the transaction and to disregard its substance. . . . In the absence of a showing that tax-avoidance motivated the transaction, we believe that this is a case for application of the basic principle that the incidence of taxation depends upon the substance, not the form, of the transaction.... The principle is not to be applied only when it benefits the government.")

The *Danielson* rule has been followed by other circuits only under circumstances comparable to the taxpayer's bad faith in that case. In *Danielson* the taxpayer was attempting to overturn an agreement by which the parties, as an element of their deal, sought to demarcate the tax consequences to each. The amount allocated to the covenant not to compete was the consideration for a premium which the purchaser agreed to pay above the

value of the stock. The taxpayer was attempting to upset the allocation after receiving the premium.

The Fifth Circuit applied the *Danielson* rule when a taxpayer was seeking to "have it both ways." In *Spector v. Commissioner of Internal Revenue,* 641 F.2d 376 (5th Cir. 1981), cert. denied, 454 U.S. 868, 102 S.Ct. 334, 70 L.Ed.2d 171 (1981), a withdrawing partner in an accounting firm agreed to remain for three days as a partner in a new firm the continuing partners were merging with so that the continuing partners could deduct amounts to be paid to the withdrawing partner. On his tax return, however, the withdrawing partner treated the payments as in liquidation of his partnership interest, which would have enabled him to claim capital gains rather than ordinary income and which would prevent the continuing partners from deducting the payments. As in *Danielson* the taxpayer was prevented from disavowing the form of the transaction when that would result in his unjust enrichment.[8]

[8]Accord: *Schatten v. United States,* 746 F.2d 319 (6th Cir. 1984) (former wife prevented from showing that what were called "support and maintenance" payments in her divorce settlement agreement were a non-taxable property settlement, which former husband could not deduct).

The potential-inconsistent-claims cases are inapplicable here, because the English lenders are not at all affected by the tax treatment of petitioners in the United States.

The conflict in the circuit court of appeals decisions is reflected in inconsistent Tax Court decisions depending on the court to which a case is appealable. The same Tax Court judge who ruled against petitioners in their 1979-80 case had earlier reached the opposite result in a case appealable to the Second Circuit. He rejected the Commissioner's argument "that, since the parties structured the transactions in the mold of leases, petitioners should be held to that mold." He held that the "leases" were really sales. (There was no potentiality of conflicting tax claims since the lessee-purchaser was a tax exempt organization.) *Rochester Development Corporation v. Commissioner,* 36 T.C.M. 1213 (1977).

Illinois Power Company v. Commissioner, 87 T.C. 1417 (1986), was appealable to the Seventh Circuit. Even though a purchaser-lessor had title, the Tax Court permitted the taxpayer to look through the form to the substance and to take deductions as owner. Similarly in *Pacific Gamble Robinson v. Commissioner,* 54 T.C.M. 915

(1987), a case appealable to the Ninth Circuit, a lessee was permitted to ignore the form and to take deductions as the owner. The Tax Court reached these results even though there were potential adverse claimants to the tax benefits in both *Illinois Power* and *Pacific Gamble Robinson.*

The Third Circuit's approach also is inconsistent with this Court's decisions permitting taxpayers to rely on the substance of a transaction rather than the form without regard to whether the taxpayer could have set aside the transaction in litigation with other parties, e.g. *Weiss v. Stern,* 265 U.S. 242, 44 S.Ct. 490, 68 L.Ed. 1001 (1924) (sale of assets to a new corporation for half cash and half stock and distribution of the cash and stock to shareholders treated as a sale by shareholders of half their stock for cash); *Helvering v. F & R Lazarus & Co.,* 308 U.S. 252, 60 S.Ct. 209, 84 L.Ed. 226 (1939) (lessee held entitled to take depreciation as owner in substance); *Helvering v. Tex-Penn Oil Co.,* 300 U.S. 481, 57 S.Ct. 569, 81 L.Ed. 755 (1937) (corporation permitted to prove it received only stock for transfer of assets, not partly cash as stated in the sale agreement); *Bartels v. Birmingham,*

332 U.S. 126, 67 S.Ct. 1547, 91 L.Ed. 1947 (1947) (dance hall operator permitted to show musicians were employees of bandleaders despite the agreement between the operator and the bandleaders); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 62 S.Ct. 540, 86 L.Ed. 775 (1942) (noteholders treated as equity owners when corporation was insolvent and creditors had taken steps to enforce their rights; taxpayer also permitted to invoke the step transaction principle); *Commissioner of Internal Revenue v. Bollinger,* 485 U.S. 340, 108 S.Ct., 1173, 99 L.Ed.2d 357 (1988) (taxpayer permitted to take deductions with respect to property held by corporate nominee to avoid state usury laws).

The Third Circuit recognized that the *Danielson* rule is difficult to reconcile with the decisions of this Court in *Lazarus, Bartels,* and *Tex-Penn, supra*. It attempted the following distinction at 378 F.2d 778:

> In contrast, in the present situation there is no discernible policy which would require that the incidence of taxation fall upon a particular individual. As a result of the circumstances that an amount allocable to a covenant not to compete is amortizable by the buyer and ordinary

> income to the seller, it generally does not matter what amount is allocated.

The distinction implies that the *Danielson* rule might not be applicable when there is no possibility of conflicting tax claims. However, the Third Circuit did not draw any such distinction in this case.

In Smith, *Substance and Form: A Taxpayer's Right to Assert the Priority of Substance*, 44 Tax Lawyer 137 (Winter 1990), the author notes that the decision in petitioners' 1979-80 case (which was reapplied in this case) was a departure from prior law with regard to when a taxpayer may look through form to the substance.

> As noted, notwithstanding that the nominal title holders were the U.K. lenders who (as the Court presumed) were not subject to U.S. tax laws and would not claim depreciation, the court nonetheless stated it would treat the transaction as if the title holders were subject to U.S. tax laws. This statement was intended to treat the case as though it involved potentially conflicting tax claims so as to invoke the Tax Court's "strong proof" rule. That seems a stretch. The preferable approach

would seem to be one that took into account that there were no potentially conflicting claims to depreciation. Accordingly the need to bind a taxpayer to its form, or to invoke the "strong proof" rule or indeed the Danielson rule, should have been substantially mitigated. 44 Tax Lawyer 157

POINT II

PENALTIES SHOULD NOT BE ROUTINELY IMPOSED UNDER IRC §6661 WHEN THE COMMISSIONER INCREASES TAX ON THE BASIS OF FORM RATHER THAN SUBSTANCE.

Not only did the petitioners lose a case they probably would have won if they resided in a state other than New Jersey, Pennsylvania, or Delaware, but the Commissioner compounded the injury by adding a 25% penalty under I.R.C. §6661 for underpayment of tax.[9] That section, however, provides that the penalty shall be abated if the taxpayer reasonably believed that his tax

[9]IRC §6661 has been repealed but substantially the same provisions were reenacted in IRC §6662, which clarified and consolidated into one section provisions on penalties which had been scattered through various provisions of the Code.

treatment "was more likely than not the proper one."[10] Even if their challenge to the *Danielson* rule were ultimately rejected, petitioners certainly have a reasonable belief that their position is more likely than not the proper one.

The effect of the Commissioner's automatic imposition of a penalty is to chill taxpayers' willingness to challenge controversial positions taken by the Commissioner because of the risk of burdensome penalties if the taxpayers lose. In this case, not only was there substantial support for the petitioners' position in decisions of this Court and other courts of appeal, but there were also grounds for distinguishing the *Danielson* case. Here there is no difference between form and substance as a matter of commercial law. There is also no possibility of inconsistent tax claims in this case, because the English lenders are not subject to United State income tax.

[10]The Tax Court added: "Nor have petitioners shown that their position was adequately disclosed as outlined by Section 6661(b)(2)." The Court did not state what more plaintiffs could have disclosed than that they were filing amended tax returns reflecting the decision in the 1979-80 tax case.

The authorities cited in Point I show that petitioners had every reason to believe that their tax treatment was the proper one. Imposition of penalties under IRC §6661 was clearly unwarranted.

Moreover, what was done here illustrates the use of penalties by IRS as an *in terrorem* tactic to discourage taxpayers from appealing controversial assessments. If the taxpayer concedes, the Service will often waive penalties. But if the taxpayer chooses to exercise his rights to appeal, then the Commissioner raises the ante by imposing penalties.[11] Such unfettered discretion is repugnant to equitable administration of tax laws.

This case presents an opportunity for this Court to make clear that there are limitations on the Commissioner's ability to impose penalties. It is imperative that it be clear that penalties may not be used as sanctions against a taxpayer who litigates a doubtful point of law, particularly when, as here, other circuits probably would have decided in the taxpayer's favor. This is fundamentally unjust.

[11]Internal Revenue Manual §8(11)(13)(2).

CONCLUSION

This Petition for a Writ of Certiorari to the United States Court of Appeals for the Third Circuit should be granted.

Respectfully submitted,

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T.C. Memo. 1989-497

UNITED STATES TAX COURT

WILLIAM COLEMAN and ARLETTE COLEMAN, ET AL., Petitioners v. COMMISSIONER OF INTERNAL REVENUE, Respondent.

Docket Nos. 17221-86, 174666-86 Filed Sept. 11, 1989
17467-86, 13516-87,
13530-87, 12531-87.[1]

Leon C. Baker, for the petitioners.

Susan G. Lewis, for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

KORNER, *Judge*:* In his notices of deficiency, respondent determined the following income tax deficiencies and additions to tax for petitioners.

[1]All six docket numbers have been consolidated for briefing and opinion.

*By order of the Chief Judge, these cases were reassigned to Judges Jules G. Korner III.

William and Arlette Coleman
Docket No. 17221-86

		Additions to Tax	
Year	*Deficiency*	*Sec. 6661*[2]	*Sec. 6659*
1981	*$57,568.53*	*-0-*	*$16,768.75*
1982	*39,891.50*	*$3,989.15*	*11,641.65*

Ronald and Nancy Coleman
Docket No. 17466-86

		Additions to Tax	
Year	*Deficiency*	*Sec. 6661*	*Sec. 6659*
1981	*$57,587.90*	*-0-*	*$16,776.57*
1982	*39,891.50*	*$3,989.15*	*11,641.65*

Harvey and Carol Coleman
Docket No. 17466-86

		Additions to Tax	
Year	*Deficiency*	*Sec. 6661*	*Sec. 6659*
1981	$57,481.61	-0-	$16,742.67
1982	39,891.50	$3,989.15	11,641.65

[2]All statutory references are to the Internal Revenue Code, as in effect in the years in issue, and all Rule references are to the Tax Court Rules of Practice and procedure, except as otherwise noted.

Harvey and Carol Coleman
Docket No. 13516-87

Year	*Deficiency*	*Additions to Tax Sec. 6659*
1983	$33,737	$10,121.10
1984	31,243	$ 9,372.90
1985	1,610	483.00

Ronald and Nancy Coleman
Docket No. 13530-87

Year	*Deficiency*	*Additions to Tax Sec. 6659*
1983	$33,728	$10,118.40
1984	13,743	4,122.90
1985	1,612	483.60

William and Arlette Coleman
Docket No. 13531-87

Year	*Deficiency*	*Additions to Tax Sec. 6659*
1983	$33,737	$10,121.10
1984	31,244	9,373.20
1985	1,610	483.00

In the notices of deficiency sent to all the petitioners for tax years 1981 through 1985, respondent also determined that Section 6621(c) (formerly section 6621(d))[3]

[3]Section 6621(d) was redesignated as Sec. 6621(c) by the Tax Reform Act of 1986, 100 Stat. 2744. See Pub. L. 99-514, Sec. 1151(c)(1)(A)-(C).

dealing with interest on substantial underpayments attributable to tax motivated transactions was applicable.

The issue presented for decision, which were limited by stipulation, are whether petitioners (i) acquired a depreciable interest in computer equipment; (ii) are entitled to deduct interest attributable to a nonrecourse note; (iii) are liable for section 6661 additions to tax attributable to substantial understatements in tax year 1982; (iv) are liable for section 6659 additions to tax for a valuation overstatement; and (v) are liable for the increased interest rate applicable to tax-motivated transactions pursuant to section 6621(c).

FINDINGS OF FACT

The above consolidated cases have been fully stipulated by the parties under Rule 122. The parties have agreed to accept the findings of fact in *Coleman v. Commissioner,* 87 T.C. 178 (1986), involving the 1979 and 1980. For economy of space and efficiency, we hereby incorporate the findings of fact in *Coleman* as part of the record in this case.

The parties have filed a Supplemental Stipulation which includes petitioners' Forms 1040 and 1040X in the

record, as well as respondent's statutory notices of deficiency for tax years 1981 through 1985.

William and Arlette Coleman resided in Saddle River, New Jersey, at the time they filed their petitions. Ronald and Nancy resided in Oradell, New Jersey, at the time they filed their petitions. Harvey and Carol Coleman resided in Upper Saddle River, New Jersey, at the time they filed their petitions.

Although the record in *Coleman* speaks for itself, a brief summary of those facts may be helpful. The three male petitioners are brothers who were equal partners in Majestic Construction Co. (Majestic), a New Jersey general partnership. Majestic was in the business of constructing and selling rental income properties for its own account. Leon Baker, who is the first cousin to the brothers and their attorney in this case, discussed Majestic's need for a tax shelter with William Coleman. The three brothers, as partners, acquired an interest in computer equipment from a computer equipment supplier (Atlantic) in the United Kingdom through several intermediary parties. Atlantic transferred title to the computer equipment to several lenders and finance

companies and arranged for leases between the lenders and its several customers. In return, Atlantic received a sum based on the discounted value of the stream of rents receivable under the arranged leases. Atlantic also entered into residual agreements with the lenders in which Atlantic retained options to repurchase the computer equipment for nominal consideration upon the expiration of the leases' initial terms. It was this interest under the residual agreement which Majestic acquired. Upon acquiring the interest in the equipment, Majestic then leased it back to its immediate seller.

Respondent claimed that the lenders were the true owners of the equipment, not Atlantic, and that Majestic, as the successor in interest to Atlantic, had no depreciable interest in the computer equipment. This Court in *Coleman* found that the *maximum* value of petitioners' interest in the equipment was $197,045.

After *Coleman* was affirmed by the Court of Appeals for the Third Circuit, petitioners filed amended income tax returns reflecting their assertion that Atlantic exercised options in Majestic's favor at various times during 1981 through 1985. In accordance with this

theory, petitioners claimed on their amended returns that they were entitled to certain reduced deductions and credits. In his statutory notices of deficiency, respondent made the following adjustments for the tax years in dispute.

William and Arlette Coleman

Year	*Increase in Share of Partnership Income*	*Disallowed Schedule E Losses*
1981	$89,773.66	$2,491
1982	77,612.00	2,172
1983	65,925.00	1,549
1984	26,088.00	1,399
1985	3,124.00	97

Ronald and Nancy Coleman

Year	*Increase in Share of Partnership Income*	*Disallowed Schedule E Losses*
1981	$89,773.66	$2,491
1982	77,612.00	2,172
1983	65,906.00	1,549
1984	26,087.00	1,399
1985	3,125.00	97

Harvey and Carol Coleman

Year	*Increase in Share of Partnership Income*	*Disallowed Schedule E Losses*
1981	$89,773.66	$2,491
1982	77,612.00	2,172
1983	65,924.00	1,549
1984	61,088.00	1,399
1985	3,124.00	97

OPINION

In *Coleman*, we held that petitioners Ronald and Nancy Coleman did not have a depreciable interest in the computer equipment during 1979 and 1980. Petitioners assert that they are now entitled to deduct depreciation, interest and other deductions because Atlantic exercised certain options on Majestic's behalf during tax years 1981 and 1985. Petitioners contend that Atlantic was required to exercise these options on their behalf under the Purchase Agreement. Petitioners bear the burden of proving that they are entitled to deductions claimed on their income tax returns for the years in dispute. Rule 142(a).

We need not determine whether petitioners would have obtained a depreciable interest in the computer equipment if Atlantic had exercised certain options. A more fundamental problem with petitioners' case is that they have not proven that these options were in fact exercised at all by Atlantic. Petitioners argue that it did not make sense for Atlantic not to exercise the options in favor of petitioners, even though they failed to introduce evidence showing that the options were actually ex-

ercised. Petitioners' attorney further suggests that he was unable to introduce evidence showing that the options had been exercised because the record in this case was limited to facts established in the earlier *Coleman* decision. We find this explanation untenable because the record in this case includes evidence which was not present in *Coleman*, such as petitioners' tax returns and respondent's statutory notices of deficiency for tax years 1981 through 1985. We note that it was petitioners' decision to accept as facts in this case the facts found, and the record supporting them, in *Coleman*, plus an additional supplemental stipulation herein. Furthermore, it strains credibility to believe that petitioners could have brought a case from petition to reply brief in this Court without providing the very piece of evidence necessary to prove their point. Petitioners have not proven that Atlantic exercised any options or that they had a depreciable interest in the computer equipment. They are not entitled to the depreciation deductions or investment tax credits that respondent disallowed. *Coleman v. Commissioner, supra*. Furthermore, petitioners are entitled to travel and entertainment

expenses only to the extent that respondent has allowed them, because petitioners have also failed to prove that they are entitled to them.

The second issue for decision is whether petitioners are entitled to deduct interest on the nonrecourse note that Majestic issued.[4] This Court in *Coleman* disallowed petitioners' deductions for interest on the nonrecourse note, holding that no genuine indebtedness existed because the price paid for the equipment ($2,055,553) and the nonrecourse note ($1,905,053) unreasonably exceeded the maximum value of the interest acquired by Majestic in 1979 and 1980, which was at most $197,045.

Petitioners claim that a genuine indebtedness existed after Atlantic exercised the options and that they should be able to deduct the interest on the nonrecourse note. Again, we decline to speculate as to what might have happened had Atlantic exercised these options because petitioners have failed to prove that they were exercised at all. We find that petitioners have the same interest in the computer equipment that they did during 1979

[4]Accepted by the Court as tried with the consent of the parties, since it was argued on brief, see Rule 41(b)(1), although the parties seemed to have excluded it as an issue in their earlier stipulation.

and 1980. No genuine indebtedness exists when the purchase price and principal amount of the nonrecourse note unreasonably exceeds the value of the property interest acquired. *Estate of Franklin v. Commissioner*, 544 F.2d 1045, 1049 (10th Cir. 1976), affg. 64 T.C. 752 (1975). We follow the opinion in *Coleman* on this issue and hold that respondent correctly disallowed petitioners' deductions for interest on the nonrecourse note during tax years 1981 through 1985.

The next issue for decision is whether petitioners are liable for additions to tax under section 6661 for substantially understating their income tax liability during 1982. Section 6661 imposes an addition to tax if there is a substantial understatement of income tax. An understatement exists when the amount of tax shown on the return is less than the amount required to be shown on the return. A substantial understatement exists when the understatement exceeds the greater of $5,000 or 10 percent of the amount of tax required to be shown on the return. An understatement may be reduced if the taxpayer's treatment of the item was based on substantial authority, sec. 6661(b)(2)(B)(i), or if the taxpayer

adequately disclosed on the return or in a statement attached to the return the relevant facts affecting such item's tax treatment. Sec. 6661 (b)(2)(B)(ii).

Petitioners argue that they need only have a "reasonable belief" that they were entitled to the deductions and credits taken in the years in dispute in order to avoid the section 6661 additions to tax. In this regard in determining whether substantial authority exists, only the following will be considered authority: applicable provisions of the Internal Revenue Code and other statutory provisions; temporary and final regulations construing such statutes; court cases; administrative pronouncements (including revenue rulings and revenue procedures); tax treaties and the regulations thereunder; and congressional intent as reflected in committee reports and other similar literature. Section 1.6661-3(b)(2), Income Tax Regs. Petitioners have not shown that any part of the understatement was supported by an analysis of such authority. Nor have petitioners shown that their position was adequately disclosed, as outlined by section 6661(b)(2)(B)(ii). We conclude that petitioners are liable for the 25 percent addition to tax

under section 6661 for tax year 1982.

We now decide whether petitioners are liable for section 6659 additions to tax because their underpayments of income tax were attributable to a valuation overstatement. A valuation overstatement exists when the value or the adjusted basis of property is at least 150 percent of its correct amount. The addition to tax is based on a graduated scale, depending on the degree of the overstatement. In this case, we observe that the maximum value of petitioners' interest in the computer equipment was $197,045. For tax purposes, petitioners claimed that the computer equipment was worth $2,055,553. With this mind, it is clear that petitioners are liable for the 30 percent addition to tax on the underpayment attributable to valuation overstatement because the value of the computer equipment claimed exceeded 250 percent of its correct amount. We note that any underpayment of tax subject to a section 6659 addition to tax attributable to a valuation overstatement is not taken into account for purposes of calculating the section 6661 addition to tax. Sec. 6661(b)(3).

Finally, we take up respondent's determination that petitioners are liable for the enhanced interest rate under section 6621(c), which is 120 percent of the interest normally charged and is levied on substantial underpayments attributable to a tax motivate transactions which exceed $1,000. "Tax motivated transactions" include, inter alia, valuation overstatements as defined by section 6659(c). Sec. 6621(c)(3)(A)(i). A valuation overstatement exists if the value or adjusted basis of any property claimed on a return is 150 percent or more of the amount determined to be the correct value or adjusted basis. Sec. 6659(c). We determined earlier that the value of $2,055,553 that petitioners claimed on their returns exceeded 250 percent of the correct value of the computer equipment. We therefore conclude that petitioners are liable for the enhanced interest rate of section 6621(c).

Decision will be entered under Rule 155.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

Nos. 90-1801; 90-1802 and 90-1803

HARVEY COLEMAN and CAROL COLEMAN,

Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE SERVICE

On Appeal from the Tax Court
(Nos. 87-13516; 87-13530 and 87-13531)
Tax Court Judge: Hon. Jules G. Korner, III

Submitted Under Third Circuit Rule 12(6)
May 16, 1991

Before: HUTCHINSON, COWEN and GARTH,
Circuit Judges

JUDGMENT ORDER

After considering the contentions raised by appellants it is

ADJUDGED AND ORDERED that the decisions of the Tax Court filed September 12, 1990, be and the same are hereby affirmed. Costs taxed against appellants.

ATTEST:
S/Sally Mrvoss, Clerk
Dated: May 22, 1991

BY THE COURT:
S/Robert E. Carver

Sec. 6661 [1986 Code] (a) ADDITION TO TAX - If there is a substantial understatment of income tax for any taxable year, there shall be added to the tax an amount equal to 25 percent of the amount of any underpayment attributable to such understatement.

(b) DEFINITION AND SPECIAL RULE. -

(1) SUBSTANTIAL UNDERSTATEMENT. -

(A) IN GENERAL. - For purposes of this section, there is a substantial understatement of income tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of -

(i) 10 percent of the tax required to be shown on the return for the taxable year, or

(ii) $5,000.

(B) SPECIAL RULE FOR CORPORATIONS. - In the case of a corporation other than an S corporation or a personal holding company (as defined in section 542), paragraph (1) shall be applied by substituting "$10,000" for "$5,000".

(2) UNDERSTATEMENT. -

(A) IN GENERAL. - For purposes of paragraph (1), the term "understatement" means the excess of -

(i) the amount of the tax required to be shown on the return for the taxable year, over

(ii) the amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

(B) REDUCTION FOR UNDERSTATEMENT DUE TO POSITION OF TAXPAYER OR DISCLOSED ITEM. - The amount of the understatement under subparagraph (A) shall be reduced by that portion of the understatement which is attributable to-

(i) the tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or

(ii) any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.

(C) SPECIAL RULES IN CASES INVOLVING TAX SHELTERS. -

(i) IN GENERAL. - In the case of any item attributable to a tax shelter -

(I) subparagrah (B)(ii) shall not apply, and

(II) subparagraph (B)(i) shall not apply unless (in addition to meeting the requirements of such subparagraph) the taxpayer reasonably believed that the tax treatment of such item by the taxpayer was more likely than not the proper treatment.

(ii) TAX SHELTER. For purposes of clause (i) the term "tax shelter" means -

(I) a partnership or other entity.

(II) any investment plan or arrangement, or

(III) any other plan or arrangement,

if the principal purpose of such

partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax.

(3) COORDINATION WITH PENALTY IMPOSED BY SECTION 6659. - For purposes of determining the amount of the addition to tax assessed under subsection (a), there shall not be taken into account that portion of the substantial understatement on which a penalty is imposed under section 6659 (relating to addition to tax in the case of valuation overstatements).

(c) AUTHORITY TO WAIVE. - The Secretary may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatment (or part thereof) and that the taxpayer acted in good faith).